(2)

No. 05-827

IN THE

Supreme Court of the United States

JAMES J. McMONAGLE, THE LEGAL REPRESENTATIVE FOR FUTURE CLAIMANTS,

Petitioner,

v.

CREDIT SUISSE FIRST BOSTON, AS AGENT, *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF RESPONDENT THE OFFICIAL COMMITTEE OF ASBESTOS CLAIMANTS IN SUPPORT OF THE PETITION

PETER VAN N. LOCKWOOD
NATHAN D. FINCH
LESLIE M. KELLEHER
CAPLIN & DRYSDALE, CHARTERED
One Thomas Circle, NW
Suite 1100
Washington, DC 20005
(202) 862-5000

ELIHU INSELBUCH
Counsel of Record
CAPLIN & DRYSDALE, CHARTERED
375 Park Avenue
35th Floor
New York, NY 100152
(212) 319-7125

Attorneys for Respondent
The Official Committee of Asbestos Claimants

199062

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

TABLE OF CONTENTS

TABLE OF CITED AUTHORITIES

Respondent the Official Committee of Asbestos Claimants of Owens Corning (the "Committee") respectfully submits this brief in support of the Petition of James J. McMonagle, Legal Representative for Future Claimants (the "Legal Representative") for a Writ of Certiorari to the Third Circuit.

PRELIMINARY STATEMENT

The Committee is the court-appointed fiduciary representing the interests of the more than 200,000 individuals who are present asbestos-related tort claimants of Owens Corning Delaware ("Owens Corning") and its subsidiaries (collectively, the "Debtors"). The interests of future tort claimants – those who will develop asbestos-related diseases in the future due to exposure to the Debtors' asbestos-containing products – are represented by the Petitioner, the Legal Representative. The present and future tort claimants are, collectively, the largest constituency by far in the Debtors' bankruptcy cases, both in terms of numbers of claimants, and in terms of the aggregate amount of their claims. The asbestos-related personal injury and wrongful death claims against Owens-Corning alone, without considering claims against its subsidiaries, were estimated by the district court below to be approximately $7 billion. Appendix to Petition for Certiorari ("Pet. App.") 67. The substantive consolidation decision of the Third Circuit in this case results in the reallocation of at least an additional $1 billion to Owens Corning's unsecured bank lenders, at the expense of its other unsecured creditors, the asbestos tort claimants and bondholders, despite the district court's clear factual finding that the bank lenders did not rely on the separate credit of any Owens Corning subsidiary in making their loans to Owens Corning. The significance of this case

goes far beyond its impact on the Owens Corning tort claimants and other creditors, however. At issue is a fundamental concept of bankruptcy law with far-reaching implications for structured finance planning, the bankruptcy system in general, and for the interests of creditors – both voluntary and involuntary – of a significant number of businesses that seek bankruptcy protection each year.

Sixty-five years ago, in *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941), this Court approved – but did not explicate – the doctrine of "substantive consolidation" in bankruptcy. Substantive consolidation, an equitable remedy, usually results, *inter alia*, in pooling the assets and liabilities of affiliated entities into one estate, satisfying claims against all of the entities from the resulting common fund, eliminating inter-company claims, and combining the creditors of the affiliated entities for voting on reorganization plans. *See* 2 COLLIER ON BANKRUPTCY ¶ 18.08 [1] (Lawrence P. King, ed., 15th ed. 2000). "The underlying purpose of this doctrine is to distribute assets equitably among all creditors." *Id.* Equity does not require, however, that each creditor have the same recovery it would have had without substantive consolidation. Indeed, "unless the asset to liability ratio of each member of the corporate group is equal" – and ordinarily it will not be – "substantive consolidation will necessarily reduce the bankruptcy distribution to some group of creditors or equity owners." Christopher W. Frost, *Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Groups*, 44 HASTINGS L. J. 449, 450-51 (1993).

Almost all of the federal courts of appeals have considered the circumstances under which substantive consolidation is appropriate, and each of those courts has

acknowledged that the remedy is necessary and appropriate under certain circumstances to ensure equality of distribution and the equitable treatment of debtors. But without guidance from this Court, the courts of appeals have adopted broadly divergent standards. Prior to the Third Circuit's decision below, the courts had primarily split between two tests which, though they share common ground, reflected significantly different approaches to the issue. The Third Circuit below in this case has adopted a third test that sharply diverges from both the primary tests used by other courts of appeals, and that virtually eliminates the remedy in that circuit, causing a three-way split among the circuits, and adding to the already substantial confusion with respect to a fundamental bankruptcy doctrine.

As a growing number of business enterprises adopt the "use of interrelated corporate structures by subsidiary corporations operating under a parent entity's corporate umbrella for tax and business purposes," (*Eastgroup Properties v. Southern Motel Ass'n., Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991)), as well as complex forms of structured financing,[1] and as tens of thousands of businesses seek bankruptcy protection each year,[2] the far-reaching impact of the doctrine of substantive consolidation cannot be disputed.

---

1. *See* 2 COLLIER ON BANKRUPTCY ¶ 18.08[8] (Lawrence P. King, ed., 15th ed. 2000). ("The equitable doctrine of substantive consolidation has become increasingly important * * * as conduit financing of business enterprises has become popular.") *See also In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518-19 (2d Cir. 1988) (noting the importance to credit markets of certainty in the law of substantive consolidation).

2. *See* ADMIN OFFICE OF THE U.S. CTS., BANKR. STATISTICS, 1990-2002 CALENDAR YEAR BANKR. FILINGS BY CH. & DIST., *passim*, http:// www.uscourts.gov/bnkrptcystats /Bk2002-1990Calendar.pdf.

Nor can it be disputed that there is an immediate and pressing need – made all the more urgent by the decision below – for clarification of the standards for application of the doctrine. The Committee respectfully submits that the time has come for this Court to revisit the issue of substantive consolidation. This case provides the ideal vehicle for the Court to provide guidance to lower federal courts on this important and fundamental bankruptcy doctrine, in order to ensure its equitable and uniform application.

THE PETITION SHOULD BE GRANTED AS THE DECISION BELOW CREATES A THREE-WAY SPLIT AMONG THE CIRCUITS ON THE STANDARDS FOR SUBSTANTIVE CONSOLIDATION

Prior to the Third Circuit's decision in this case, the nine other circuit courts of appeals that had considered the issue of substantive consolidation had articulated varying rationales – and standards – for ordering the equitable remedy. Over several decades, the law has coalesced to the point that the circuits are primarily split over two standards: the test articulated by the Second Circuit in *In re Augie/Restivo Baking Co.*, 860 F.2d 515 (2d Cir. 1988), and the test adopted by the D.C. Circuit in *In re Auto-Train Corp.*, 810 F.2d 270 (D.C. Cir. 1987).

In *Auto-Train*, the D.C. Court of Appeals set out a two-part balancing test. The proponent of consolidation must first make a *prima facie* case that there is "a substantial identity between the entities to be consolidated [and] that consolidation is necessary to avoid some harm or realize some benefit." 810 F.2d at 276. *Accord In re Giller*, 962 F.2d 796, 799 (8^{th} Cir. 1992); *Eastgroup Properties v. Southern Motel*

Ass'n., Ltd., 935 F.2d 245, 249 (11th Cir. 1991). The burden of proof then shifts to an objecting creditor to demonstrate that "it relied on the separate credit of one of the entities and that it will be prejudiced by consolidation." 810 F.2d at 276. If the creditor makes such a showing, "the court may order consolidation only if it determines that the demonstrated benefits of consolidation 'heavily' outweigh the harm." *Id.*

In *Augie/Restivo*, the Second Circuit reviewed the "numerous considerations" mentioned in previous cases as "relevant to determining whether equitable treatment will result from substantive consolidation." *Augie/Restivo*, 860 F.2d at 518. Those considerations included, *inter alia*, whether creditors knowingly dealt with the corporations as a unit; whether the interrelationships of the group were closely entangled; and whether the entanglement of business affairs of related corporations was so extensive that the cost of untangling would outweigh any benefit to creditors.[3] The Second Circuit held that "these considerations are merely variants on two critical factors" in determining whether substantive consolidation is justified: "(i) whether creditors dealt with the entities as a single economic unit and 'did not rely on their separate identity in extending credit,'" * * * or (ii) whether the affairs of the debtor are so entangled that consolidation will benefit all creditors." *Augie/Restivo*, 860 F.2d at 518 (citations omitted). *Accord In re Baker & Getty Fin. Servs., Inc.*, 974 F.2d 712, 720 (6th Cir. 1992); *In re Bonham*, 229 F.3d 750, 766 (9th Cir. 2000) ("The presence of either factor is a sufficient basis to order substantive consolidation.")

3. This line of authority sets out what has been described as the "alter ego" test for substantive consolidation, a test closely related to state-law theories of "piercing the corporate veil". *See* 2 COLLIER ON BANKRUPTCY ¶ 18.08[5][a] (Lawrence P. King, ed., 15th ed. 2000).

While the *Auto-Train* and *Augie/Restivo* lines of authority have a commonality of approach – particularly in that a central focus of both tests is whether the opposing creditor specifically relied on the separate credit of the entities – the tests also have significant differences. The *Auto-Train* test is clear, for example, that even where an objecting creditor can demonstrate that it relied on the separate credit of one of the entities, the interests of all creditors will still be balanced, and if the aggregate benefits heavily outweigh the harm to the opposing creditors, substantive consolidation will be allowed. Thus, the *Auto-Train* test specifically provides – correctly, the Committee contends – that in an appropriate case the interests of involuntary, or tort, creditors could trump those of a voluntary creditor who extended credit in reliance on the creditworthiness of a separate entity. In addition, while the *Augie/Restivo* test does not address the burden of proof, the *Auto-Train* test provides specific guidance on that issue. The conflict between the two lines of authority, and the attendant confusion in the law, provided ample reason for clarification of the doctrine by this Court. The Third Circuit has now articulated yet a third test, which diverges sharply from both the *Auto-Train* and *Augie/Restivo* tests, exacerbates the confusion in the law, and amplifies the need for this Court's guidance on the issue.

Under the Third Circuit's new test, the proponents of substantive consolidation must prove either that "(i) prepetition [the debtors] disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors." Pet. App. 26. In articulating its new test, the Third Circuit began with the premise that "corporate disregard as a fault

may lead to corporate disregard as a remedy." Pet. App. 15. Thus, the first prong of the test focuses on the malfeasance of the debtors in disregarding corporate separateness, rather than focusing on equitable treatment of creditors. Significantly – and in stark contrast to both the *Auto-Train* and *Augie/Restivo* tests – the Third Circuit's test does not take into consideration at all whether an opposing creditor relied on the ***separate credit*** of the entities, but only whether the creditor treated them as ***separate legal entities***. Pet. App. 31. In this case, for example, the district court made a clear factual finding that the banks opposing substantive consolidation had looked to the "overall credit of the entire Owens Corning enterprise" in extending credit. Pet. App. 51. Thus, substantive consolidation would not defeat the opposing banks' expectations or prejudice them in any way (Pet. App. 50), but would provide them with exactly what they had bargained for. Such a finding weighs heavily in favor of the equitable remedy under both the *Auto-Train* and *Augie/Restivo* tests, and was significant to the determination of the district court below that the remedy was appropriate in this case. Under the Third Circuit's test, however, reliance on separate ***credit*** is irrelevant (Pet. App. 31); all that matters is that the creditors relied on the "existence of separate legal entities" (Pet. App. 31), a standard that is easily met by almost any voluntary creditor and which, in this case, resulted in reversal.

Unlike the *Auto-Train* test, under the Third Circuit's test there is no balancing of creditors' interests. Indeed, the interests of tort creditors are given no weight at all. Proponents of substantive consolidation – who, in stark contrast to the *Auto-Train* test, bear the burden of persuasion throughout (Pet. App. 27) – must demonstrate their reliance on the debtors' supposed unity. As the court below explicitly

stated, involuntary creditors such as tort creditors cannot, by definition, satisfy such a burden, as they did not rely on anything in becoming creditors. Pet. App. 27, n. 21. This reasoning turns equity on its head. Tort claimants, unlike voluntary creditors, are not in a position to bargain for protection against the layers of limitations on liability in corporate groups, and have the greatest need for the remedy afforded by substantive consolidation. *See generally,* Frost, *supra*, at 452-53. But rather than considering the overall equities of substantive consolidation for all creditors, the court further ruled that, under the second prong of the test, commingling of assets will justify substantive consolidation only when *every* creditor will benefit, that is, only in the rarest of cases when substantive consolidation would result in every creditor receiving an increased distribution Pet. App. 31.

The court emphasized that, in its view, substantive consolidation is not justified where it would result in a reduced distribution to any contract creditor:

> "Communizing" assets of affiliated companies to one survivor to feed all creditors of all companies may to some be equal (and hence equitable). But it is hardly so for those creditors who have lawfully bargained prepetition for unequal treatment by obtaining guarantees of separate entities.

Pet. App. 36. Thus, under the Third Circuit standard, any contract creditor now can defeat substantive consolidation virtually automatically on the ground that its recovery will be reduced – which necessarily happens in almost all substantive consolidations.